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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF SWITZERLAND

REF: (A) EDR(77)3; (B) STATE 28569; (C) BERN 495;
(D) OECD PARIS 3386

1. SUMMARY: AT FEBRUARY 9 EDRC REVIEW, SWISS DEL (LED BY L'HUILLIER, UNIVERSITY OF GENEVA) ASSURED COMMITTEE THE GOS WAS NOT DEVELOPING ZERO GDP GROWTH STRATEGY. SWISS DID, HOWEVER, SEE SLOW (1.5 PERCENT) GROWTH IN 1977 AS AN ACCEPTABLE OUTCOME, AND ARGUED THAT, IN ANY CASE, CONSTRAINTS ON GOS ABILITY TO STIMULATE DOMESTIC DEMAND WOULD RENDER SUCH OUTCOME ALMOST INEVITABLE. NEITHER SECRETARIAT NOR MOST EDRC DELS WERE TOTALLY CONVINCED BY L'HUILLIER'S ARGUMENTS AND UNDERLINED RESPONSIBILITY OF STRONG COUNTRIES UNDER OECD'S MEDIUM-TERM STRATEGY TO HELP LEAD WEAK COUNTRIES OUT OF DOLDRUMS. EDRC CON-
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CLUDED BY URGING GOS TO AVOID REGRESSIVE MEDIUM-TERM PATH CHARACTERIZED BY MUTUALLY RE-ENFORCING PROCESS OF DECLINE IN ACTIVE POPULATION AND REDUCTION IN POTENTIAL OUTPUT. GOS FORECASTS DECELERATION OF EXPORT AND IMPORT GROWTH IN 1977, DETERIORATION OF TERMS OF TRADE AND CONSEQUENT APPEARANCE OF TRADE DEFICIT; THEY DID NOT, HOWEVER, DISAGREE WITH SECRETARIAT PROJECTION OF INCREASED

CURRENT ACCOUNT SURPLUS. SWISS EXPECT MINIMAL UPWARD PRESSURE ON FRANC THIS YEAR AND NOTED THAT OFFICIAL INTERVENTION IN EXCHANGE MARKET WOULD BE CONSTRAINED BY TARGET FOR GROWTH OF M1 IN 1977 (5 PERCENT). L'HUILLIER STRESSED THAT MOVE TO MORE FLEXIBLE EXCHANGE RATE REGIME AND CONSEQUENT ELIMINATION OF UNDERVALUATION OF FRANC, HAD ENTRAINED NEED FOR MAJOR STRUCTURAL ADJUSTMENTS, FACILITATION OF WHICH WILL REMAIN CENTRAL TO GOS POLICY CONCERNS. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: GOS CONTINUES TO FORECAST REAL GDP GROWTH OF ONLY 1.5 PERCENT IN 1977. SWISS FELT, HOWEVER, THAT RECENT PICKUP IN PRIVATE CONSUMPTION SPENDING, TOGETHER WITH ENHANCED BUSINESS CONFIDENCE INDUCED BY RECENT STABILITY IN EXCHANGE MARKET, COULD BE CAUSE FOR INCREASED OPTIMISM. NONETHELESS, SWISS SAID THAT ROOM FOR EXPANSION OF DOMESTIC DEMAND WAS SUBSTANTIALLY LESS THAN WOULD BE IMPLIED BY CURRENTLY ESTIMATED RATE OF CAPACITY UTILIZATION (80 PERCENT). IN PARTICULAR, THEY NOTED THAT (A) WHILE AVERAGE CAPACITY UTILIZATION RATE WAS 80 PERCENT, DISPERSION AROUND AVERAGE WAS GREAT; (B) IN SECTORS WHERE EXCESS CAPACITY WAS GREATEST (I.E., CONSTRUCTION, TEXTILES, ETC.) STRUCTURAL SHIFTS HAD RENDERED IMPORTANT PART OF CAPITAL STOCK ECONOMICALLY OBSOLETE; (C) ACTIVE POPULATION DECLINED 10 PERCENT OVER LAST THREE YEARS AND EXPECTED TO FALL ANOTHER 1 PERCENT IN 1977; THIS FACTOR TOGETHER WITH DECLINE IN ECONOMICALLY RELEVANT CAPITAL STOCK HAS HAD ADVERSE EFFECT ON LONG RUN GROWTH LIMITED OFFICIAL USE

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OF POTENTIAL OUTPUT.

3. PICKING UP SWISS POINT RE DECLINE IN ACTIVE POPULATION, SEVERAL DELS CRITICIZED GOS POLICY WITH RESPECT TO FOREIGN WORKERS. U.K. NOTED THAT SWITZERLAND WAS ONE OF FEW OECD COUNTRIES LITERALLY TO HAVE EXPORTED UNEMPLOYMENT DURING RECENT RECESSION. SWISS ARGUED THAT THE DEPARTURE OF 200,000 FOREIGN WORKERS SINCE 1975 SHOULD BE SEEN IN SOMEWHAT BROADER PERSPECTIVE: (A) OUTFLOW WAS CONFINED TO "CONTROLLED WORKERS" (TEMPORARY) WHILE NUMBER OF "PERMANENT" FOREIGN WORKERS (310,000) REMAINED CONSTANT; (B) OUTFLOW OF CONTROLLED WORKERS SINCE 1975 WAS NOT A NEW DEVELOPMENT, BUT REPRESENTED AN ACCELERATION OF A TREND; 100,000 OF THESE WORKERS HAD DEPARTED BEFORE ONSET OF RECESSION. SPANISH DEL EXPRESSE VIEW THAT GOS HAD ACTED HASTILY IN REDUCING FOREIGN LABOR

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COMPLEMENT IN ADVANCE OF COMPLETING STRUCTURAL ADJUSTMENTS, WHICH WOULD REDUCE DEPENDENCE OF SWISS ECONOMY ON THESE WORKERS; RECOVERY COULD THUS BE IMPEDED BY LABOR SHORTAGE. SWISS ADMITTED THAT THIS WOULD BE THE CASE AND ADDED THAT DEPARTURE OF FOREIGN WORKERS SHOULD NOT BE REGARDED AS HAVING SHIELDED SWISS FROM EMPLOYMENT IMPACT OF RECESSION SINCE RESULTING DROP IN BOTH PRIVATE CONSUMPTION AND REQUIREMENTS FOR INFRASTRUCTURE INVESTMENT HAD HAD EFFECTS THROUGHOUT SWISS ECONOMY.

4. SWISS PLACED CONSIDERABLE EMPHASIS ON THEIR CONQUEST OF INFLATION IN 1976. THEY ATTRIBUTED THEIR SUPERIOR PRICE PERFORMANCE TO FALL IN EXTERNAL AND INTERNAL DEMAND, TO APPRECIATION OF FRANC AND TO RAPID ADJUSTMENT OF WAGES TO DECELERATION IN INFLATION RATE. U.S. NOTED (PER REF D) THAT STANCE OF GOS DEMAND MANAGEMENT POLICIES OVER LAST TWO YEARS COULD NOT BE CHARACTERIZED AS ESPECIALLY ANTI-INFLATIONARY. SWISS RESPONDED THAT WHILE IT WAS DIFFICULT TO IDENTIFY WHAT ROLE POLICIES MIGHT HAVE PLAYED, PRUDENT MONETARY POLICY WAS PROBABLY AN IMPORTANT FACTOR.

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(HOWEVER, SWISS PRIVATELY INDICATED THEIR AGREEMENT WITH U.S. VIEW.) EDRC CONCLUDED THAT POLICIES MUST HAVE PLAYED SOME PART IN REDUCING INFLATION AND THAT IT WOULD BE "IMPOLITE" TO SUGGEST THAT SWISS GOT THESE RESULTS WITH NO STATISTICS, NO POLICY, NO FORECASTS, AND LOTS OF LUCK. SWISS ALSO STATED THAT HIGH DEGREE OF SOCIAL CONSENSUS ASSISTED UNWINDING INFLATION, BUT AT SAME TIME REJECTED UTILITY OF INCOME POLICIES, NOTING INSTEAD THAT INFLATION IS ESSENTIALLY A DEMAND PHENOMENON. LIKE SECRETARIAT, SWISS EXPECT SOME ACCELERATION IN INFLATION RATE IN 1977 DUE TO INCREASE IN FOOD AND FUEL PRICES. IN ADDITION, THEY ESTIMATE THAT SWITCH TO VAT, IF APPROVED IN JUNE REFERENDUM, WOULD INCREASE (ASSUMING FULL PASS-THROUGH) CONSUMER PRICES BY 2-3 PERCENT.

5. CURRENT ACCOUNT: LARGE SWISS (\$3.9 BILLION) CURRENT ACCOUNT SURPLUS IN 1977 AND ITS EXPECTED WIDENING TO ABOUT \$4.2 BILLION IN 1977 DREW HEAVY CRITICISM FROM SECRETARIAT AND FROM SEVERAL EDRC DELS. SECRETARIAT STRESSED STRONG COUNTRY RESPONSIBILITY UNDER OECD'S MEDIUM-TERM STRATEGY TO PROVIDE EXPANDING MARKETS FOR WEAK COUNTRIES' EXPORTS, AND SAID THAT THIS STRATEGY THUS CALLED FOR MORE RAPID EXPANSION OF DOMESTIC DEMAND IN 1977 THAN WAS OFFICIALLY FORECAST (1.9 PERCENT). SWISS COUNTERED SECRETARIAT POSITION WITH ARGUMENTS ALONG FOLLOWING LINES: (A) TRADE BALANCE WAS NEARLY IN EQUILIBRIUM IN 1976 AND IS EXPECTED TO SWING INTO DEFICIT THIS YEAR; CURRENT ACCOUNT SURPLUS PRIMARILY GENERATED BY NET INCOME FROM FOREIGN INVESTMENTS (I.E., GNP SUBSTANTIALLY EXCEEDS GDP) AND IS THUS FINANCIAL RATHER THAN A "REAL" SURPLUS AND NOT INDICATIVE OF UNDERUTILIZATION OF RESOURCES DOMESTICALLY; (B) SMALL MARGIN OF EXCESS CAPACITY LIMITS GOS ABILITY TO EXPAND DOMESTIC DEMAND (SEE PARA 2 ABOVE); (C) INCREASE OF PUBLIC SECTOR DEFICIT DESIRED NEITHER BY GOS NOR BY SWISS PUBLIC AND WOULD HEIGHTEN DANGER OF INFLATION IN 1978-79; MOREOVER EXCESS LIMITED OFFICIAL USE

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SIVE RISE IN PUBLIC SPENDING WOULD RISK PRODUCING AN UNDESIRABLE INCREASE IN IMPORTANCE OF PUBLIC SECTOR RELATIVE TO PRIVATE SECTOR. SECRETARIAT AGREED THAT FASTER GROWTH OF DOMESTIC DEMAND MIGHT BE DETERRED BY CAPACITY CONSTRAINTS AND HAS NOTED THIS FACTOR IN DRAFT SURVEY. (SECRETARIAT SUGGESTED THAT GOS MIGHT INCREASE ITS FOREIGN AID.) HOWEVER, REFERRING TO POINT (A) ABOVE, SECRETARIAT SAID BASIC PROBLEM IN OECD AREA WAS UNSUSTAINABLE MALDISTRIBUTION OF OECD'S CURRENT ACCOUNT DEFICIT; SEEN IN THIS CONTEXT, IT WAS IRRELEVANT THAT SWISS CURRENT ACCOUNT SURPLUS RESULTED FROM NET INVESTMENT INCOME FROM ABROAD, RATHER THAN FROM TRADE SURPLUS.

6. EXCHANGE RATE POLICY: SWISS FELT THAT DEMISE OF
FIXED EXCHANGE RATE SYSTEM AND ADVENT OF "MANAGED FLOAT-
ING" HAD BY ELIMINATING THE UNDERVALUATION OF THE SWISS FRANC,
PRECIPITATED (THEY DID NOT SAY "CAUSED") THE
STRUCTURAL PROBLEMS WITH WHICH THEY ARE NOW GRAPPLING.
MOREOVER, THEY INDICATED THAT EXCHANGE RATE INSTABILITY,
WHICH HAS USUALLY RESULTED IN APPRECIATION OF FRANC HAS
SHAKEN THE CONFIDENCE OF BUSINESS AND HAS THUS, IN SHORT
RUN, HAD MORE IMPORTANT ADVERSE EFFECT ON INVESTMENT
THAN ON EXPORT PERFORMANCE. SWISS SAID THAT GOS INTENDS
TO MODERATE POSSIBLE PRESSURE FOR APPRECIATION OF FRANC

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IN 1977, BUT THAT THIS GOAL WILL BE SUBSERVIENT TO THAT
OF MAINTAINING TARGETED GROWTH OF M1. THEY DO NOT EXPECT
TO FACE A TRADEOFF BETWEEN THESE TWO OBJECTIVES SINCE
GOS FEELS THAT UPWARD PRESSURE ON FRANC WILL NOT BE
STRONG. (THEY DID NOT EXPRESS INTENTION TO DISMANTLE
EXISTING CONTROLS ON CAPITAL INFLOWS.)

7. FISCAL AND MONETARY POLICY: IN REFDOC, SECRETARIAT
NOTED THAT BUDGET DEFICIT OF CONFEDERATION IN 1977
WOULD COME TO ABOUT 1.6 PERCENT OF GDP AND THAT FISCAL
POLICY WOULD HAVE RELATIVELY SMALL AND DIMINISHING

IMPACT ON GDP GROWTH IN 1977. SWISS NOTED THAT RECENT DATA SHOWED PUBLIC EXPENDITURE SHORT-FALL IN 1976 WHICH WOULD BE MADE UP THIS YEAR WITH RESULT THAT (A) PUBLIC CONSUMPTION AND PUBLIC INVESTMENT WOULD REMAIN STABLE COMPARED WITH DECLINES OF 1.8 PERCENT AND 24.6 PERCENT RESPECTIVELY PROJECTED EARLIER; (B) COMBINED DEFICIT OF ALL GOVERNMENTS COULD COME TO 2.5 PERCENT OF GDP. SWISS STRESSED THAT FURTHER INCREASE IN PUBLIC SECTOR DEFICIT WOULD BE NEITHER APPROPRIATE NOR DESIRABLE. IN ADDITION LIMITED OFFICIAL USE

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TO PROBABLE INFLATIONARY IMPACT OF LARGER BUDGET DEFICIT, THEY MADE FOLLOWING POINTS: (A) PUBLIC OPINION PREDISPOSED AGAINST LARGER DEFICIT (AS IS GOS); WHILE PUBLIC NOT AGAINST COUNTERCYCLICAL DEFICIT SPENDING PER SE, CASE WOULD HAVE TO BE CONVINCINGLY MADE; (B) DRIVING FORCE OF SWISS ECONOMY IS PRIVATE MARKET MECHANISM. INCREASE IN ROLE OF PUBLIC SECTOR WOULD DESTROY MARKET FORCES AND IMPEDE RESTRUCTURING EFFORT NOW UNDER WAY. SELECTIVE MEASURES (PRESUMABLY INCLUDING THOSE AIMED AT STIMULATING EXPORTS) HAVE SAME DRAWBACKS AS GENERALIZED INCREASE IN FISCAL POLICY STIMULUS; (C) INCREASE IN PUBLIC SPENDING COULD HAVE DANGEROUSLY LARGE EFFECT ON BUDGET DEFICIT BECAUSE OF REVENUE INELASTICITY OF TAX SYSTEM. CONSIDERATION MIGHT BE GIVEN TO CUT IN DIRECT TAXES (SECRETARIAT PROPOSAL) IF IMPLEMENTATION OF VAT WERE APPROVED IN JUNE REFERENDUM. MORE BROADLY, SWISS STATED THAT UNLESS GDP GROWTH TURNS OUT WEAKER THAN CURRENTLY FORESEEN, NO FURTHER FISCAL STIMULUS IS IN OFFING.

8. MONETARY POLICY: SWISS DESCRIBED GOS MONETARY POLICY AS "PRUDENTLY EXPANSIONARY" AND SAID THAT ITS PRIMARY GOALS WOULD REMAIN TO (A) LUBRICATE GROWTH OF GDP; (B) INSURE PRICE STABILITY, AND (C) AVERT FLUCTUATION IN VALUE OF FRANC -- READ PREVENT EXCESSIVE APPRECIATION. THUS, GOS INTENDS TO HOLD GROWTH OF M1 TO 5 PERCENT IN 1977. EDRC DID NOT EXPLORE POSSIBLE INCONSISTENCY BETWEEN SWISS STATEMENT THAT MONETARY POLICY WOULD BE SET TO AVOID EXCESSIVE APPRECIATION OF FRANC AND STATEMENT THAT EXCHANGE RATE POLICY WOULD BE HOSTAGE TO ADHERENCE TO TARGETED GROWTH OF MONEY SUPPLY. GOS IS EVIDENTLY HOPING THAT MARKET PRESSURES WILL NOT FORCE IT TO CHOOSE BETWEEN THESE OBJECTIVES THIS YEAR.

9. SECRETARIAT NOTED THAT FORECASTED GDP GROWTH FOR 1977 IMPLIED THAT SWISS WOULD HAVE TO ACHIEVE GROWTH RATE OF 4-5 PERCENT IN 1978-1979 IN ORDER TO HIT AVERAGE GROWTH LIMITED OFFICIAL USE

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RATE OF 2 PERCENT PER ANNUM (1976-1980) ENVISAGED IN
OECD'S MEDIUM-TERM GROWTH "SCENARIO." SECRETARIAT WAS
NOT OPTIMISTIC CONCERNING GOS ABILITY TO PULL THIS OFF.
EDRC CONCLUDED BY CAUTIONING SWISS TO AVOID "REGRESSIVE
PATH" OF DECLINING PARTICIPATION RATES AND SLOW GROWTH
OF POTENTIAL AND ACTUAL OUTPUT.

10. POINTS RAISED REF B PARAS 3, 4, 5, 6, AND 7 DIS-
CUSSED PARAS 2, 3, 5, 8 AND 7. QUESTIONS ADDRESSED
REF C PARAS 1(A), 1(D), AND 1(E), COVERED PARAS 4, 8,
AND 7.
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